Internal Revenue Service

memorandum

CC:TL-N-1349-92
FS:IT&A:TCOswald

date: DEC 5 1991

to: District Counsel, Los Angeles W:LA
Attn: Mr. Joseph Fletcher

from: Assistant Chief Counsel (Field Service) CC:FS

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subject [redacted]

This is in response to your November 7, 1991 request for tax litigation advice.

ISSUE

Whether the taxpayer's substantial understatement of tax liability under I.R.C. § 6661 was for reasonable cause and in good faith pursuant to the waiver requirements of section 6661(c) and Treas. Reg. § 1.6661-6(b).

CONCLUSION

Our review of the available information indicates that there are significant litigation hazards concerning the waiver of the section 6661 penalty. We recommend settlement, if possible, at an amount in your discretion. However, we also do not believe the facts, as presently known, are so in favor of the taxpayer that they necessarily compel the exercise of the Commissioner's waiver authority at this time. If settlement cannot be reached, then this issue should be litigated. Concession of this issue can be more appropriately considered after the facts are fully developed at trial. National office policy requires that Tax Court briefs, in cases in which field service advice has been requested, must be submitted to the national office for review before filing with the Tax Court. If the case is tried, we would reconsider whether concession of this issue is appropriate at the time you submit a Tax Court brief for national office review.

You have not requested our advice about the automatic waiver of the section 6661 penalty because the taxpayer may have filed qualified amended returns pursuant to Treas. Reg. § 1.6661-6(c). However, if you believe that the facts show that the requirements of automatic waiver for a qualified return, as contained in Treas. Reg. § 1.6661-6(c), have been met, you should concede this issue, unless settlement is otherwise available.

We base our recommendation on the facts, as provided to Mr. Tom Oswald of this Branch, by Mr. Joseph K. Fletcher of your office, through telephone conferences and facsimile transmissions. The facts, as we understand them, follow.

During [redacted], [redacted] ("taxpayer") invested in a research and development tax shelter partnership known as [redacted] ("[redacted]"), located in California. The taxpayer's investment in [redacted] amounted to approximately $[redacted], financed with $[redacted] cash, and a loan from [redacted] ("[redacted]") for the balance. The taxpayer's limited partnership interest in [redacted] amounted to [redacted] percent. The loan was due in ten years, but, as of this date, remains unpaid. [redacted] hired [redacted] ("[redacted]"), a research and development firm located in Switzerland, to develop a sophisticated computer software program which would enhance commodity trading profits. There was also some type of marketing agreement, but we are unsure of that arrangement. Apparently, [redacted], [redacted] and [redacted] were all related entities formed by the promoter of the shelter. [redacted] has never performed any research and development. The taxpayer's respective allocable shares of loss from [redacted]'s research and development expenditures amounted to $[redacted] and $[redacted] in [redacted] and [redacted]. The taxpayer's joint Federal income tax returns for those years were prepared by the accounting firm of [redacted], who relied upon [redacted]'s K-1s and the offering prospectus.

The taxpayer's decision to invest in [redacted] was based, in part, on the [redacted] prospectus. You informed us that the prospectus did not include the typical tax information normally found in offering memoranda issued by promoters of abusive tax shelters. While the prospectus included a tax opinion, it did not specify any exact tax benefits, and did not provide any warnings about possible adverse tax consequences such as the imposition of the substantial understatement penalty.

The tax opinion attempted to justify any research and development expenses which were to occur in the early years of [redacted]'s existence, under the rationale of Snow v. Commissioner, 416 U.S. 500 (1974). Snow allowed a limited partner deductions for losses under section 174 for research and development expenditures, in a year in which no finished product was available for marketing. It is your opinion that, overall, the prospectus emphasized the potential profitability of the venture, rather than its tax attributes. The taxpayer also traveled to Switzerland, with a business advisor, to investigate [redacted] before deciding to invest in [redacted]. We assume the advisor was independent and not affiliated with any of the shelter entities or the promoter. The content of the meeting and the extent of the business advisor's advice are unknown.

In [redacted], a partnership level proceeding was commenced involving [redacted]. A Notice of Beginning of Administrative

Proceeding ("NBAP") was issued to the Tax Matters Partner ("TMP") of [redacted] on [redacted]. Shortly after the NBAP was issued, the taxpayer, on [redacted], filed amended returns for the [redacted] and [redacted] taxable years correcting the [redacted] deductions, to the extent the deductions exceeded cash invested. There is some indication in the materials provided to us that the taxpayer was aware that the Service would make a settlement offer, at some time in the future, similar to the position reflected on the taxpayer's amended returns. Based on correspondence submitted to the Service by the taxpayer dated [redacted], the taxpayer paid the tax attributable to the adjustments at the time he filed the amended returns. It is uncertain whether this action was prompted by the receipt of the NBAP or the fraudulent acts of the promoter. The partners commenced a fraud action against the promoter on [redacted].

Subsequently, the TMP and the Service entered into a settlement agreement concerning [redacted]'s losses; however, as noted above, the taxpayer had already filed amended returns reflecting this agreement. Unfortunately, due to a fire bombing at the Glendale office, you have been unable to locate much of this information.

The revenue agent's report ("RAR"), dated [redacted], which was prepared on [redacted], indicates that the section 174 research and development expenditures were challenged because they were never made in connection with a trade or business. The focus of the RAR was on the TMP's inability to substantiate the existence of a trade or business. The RAR made no determination of whether [redacted] was a sham or whether [redacted] had a profit motive. In recommending the allowance of a deduction for cash out of pocket, the RAR states "because the taxpayer did file suit against the promoter upon discovery of the worthlessness of the computer programs, it is reasonable to conclude that the partners did in fact enter into the partnership with the expectation of receiving a profit from the transaction. On that basis, the loss would meet the requirements of section 165 of the Internal Revenue Code as a loss from a transaction entered into for profit."

The RAR also contains a supplemental penalty report for the imposition of the section 6661 substantial understatement penalty. The RAR considers reduction of the amount of the understatement subject to the section 6661 penalty, but concludes that such reduction is not warranted because there was not adequate disclosure under section 6661(b)(2)(B). The RAR does not consider whether the taxpayer had substantial authority for his position under the same section, or whether the appropriate circumstances to waive the penalty were present under section 6661(c) and Treas. Reg. § 1.6661-6(b).

The taxpayer submitted a letter to the Service dated [redacted], which contains information concerning the taxpayer's

investigatory trip to Switzerland. However, there is no information which shows whether this information was ever considered by the Service as part of a decision not to waive the section 6661 penalty, under section 6661(c), either before or after the RAR was prepared. Before the RAR was prepared, it appears that the only information submitted to the Service on behalf of the taxpayer's position was the prospectus.

The affected item statutory notice of deficiency (for the section 6661 penalties) was issued for the respective taxable years [redacted] and [redacted] on [redacted] and [redacted]. The taxpayer timely filed a petition with the Tax Court. In opposition to the section 6661 penalties, the taxpayer raises substantial authority, that he filed "qualified amended returns," that the penalty does not reach the statutory minimum for the [redacted] taxable year, and that the Service should exercise its discretionary waiver authority under Treas. Reg. § 1.6661-6(b). You have asked us to consider only the waiver issue.

Based upon the facts provided, the taxpayer appears to be a sophisticated investor. His [redacted] tax return indicates interest income of $[redacted], capital gain of $[redacted], business income of $[redacted], a net operating loss of $[redacted] and other losses which include the [redacted] loss. The taxpayer's [redacted] return has similar entries. The taxpayer owns a successful construction company and uses [redacted] as accountants. He travels with a business advisor. Since the taxpayer was a resident of Florida at the time he filed his petition in the Tax Court, this case would be appealable to the Eleventh Circuit Court of Appeals.

DISCUSSION

In general, section 6661 provides an addition to tax for an understatement of tax liability which comes within the definition of a substantial understatement of income tax. The Commissioner may waive all or a part of a section 6661 penalty if the taxpayer shows that there was reasonable cause and good faith. Thus, the burden is on the taxpayer to come forward with facts sufficient to support the conclusion that there was reasonable cause for the understatement and that the taxpayer acted in good faith. I.R.C. § 6661(c); Treas. Reg. § 1.6661-6(b).

The Commissioner's denial of the section 6661 penalty is reviewable by a court on an abuse of discretion standard. Mailman v. Commissioner, 91 T.C. 1079, 1083 (1988). Therefore, unless the Commissioner's discretion has been exercised arbitrarily, capriciously, or without sound basis in fact, a court should not substitute its judgment for that of the Commissioner. Mailman, 91 T.C. at 1084.

The regulations point out that the most important factor in making a waiver determination under section 6661 is the "extent

of the taxpayer's effort to assess the taxpayer's proper tax liability under the law." Treas. Reg. § 1.6661-6(b). Reliance on the advice of a professional does not necessarily constitute a showing of reasonable cause or good faith unless, under the circumstances, such reliance was reasonable and the taxpayer acted in good faith. Id.

In Heasley v. Commissioner, 902 F.2d 380 (5th Cir. 1990), the Fifth Circuit Court of Appeals held that the Commissioner abused his discretion in failing to waive the section 6661 addition to tax. The Heasleys claimed to have relied on the advice of a financial consultant and an accountant, recommended by the consultant, in claiming deductions generated by a tax shelter. The court found that the taxpayers acted in good faith in relying on these advisors, given the taxpayer's inexperience and lack of education. Although Heasley may be read to apply only to unsophisticated taxpayers (which the taxpayer in the present case is not), a recent Louisiana case, Rousseau v. United States, No. 90-2333 (E.D. La. April 30, 1991) [91-1 USTC 50,252] has applied Heasley to relieve a sophisticated taxpayer of liability for the section 6661 penalty. But see Freytag v. Commissioner, 904 F.2d 1011 (5th Cir. 1990).

Since Heasley, we have witnessed a trend on the part of the courts to relieve taxpayers of liability for the section 6661 penalty under the waiver exception. See Vorsheck v. Commissioner, No. 90-70266 (9th Cir. May 16, 1991); Lyons v. Commissioner, T.C. Memo. 1991-84; Varney v. Commissioner, T.C. Memo. 1991-44. Although the courts have been stating the correct standard of review, i.e., abuse of discretion, their holdings amount to de novo determinations.

Karr v. Commissioner, 924 F.2d 1018 (11th Cir. 1991), aff'g, 91 T.C. 733 (1988) is the only case we discovered in which the Eleventh Circuit Court of Appeals considered the Service's refusal to waive a section 6661 penalty under section 6661(c). The taxpayer invested in an alternative energy tax shelter which was determined by the Tax Court to be a sham. In review of the section 6661(c) waiver issue, the Eleventh Circuit adopted the Mailman abuse of discretion standard, and held that the Commissioner's position was not maintained for any improper purpose. However, in doing so, it appears the Eleventh Circuit also made a de novo determination on the facts. The Eleventh Circuit stated that since the offering memoranda alerted the taxpayer to possible Service challenges in the event of an audit, and the taxpayer's CPA explicitly informed the taxpayer that the substantial understatement could be imposed, the Tax Court correctly concluded that the Commissioner did not abuse his discretion. Karr, 924 F.2d at 1026. Neither the Tax Court nor the Eleventh Circuit considered the taxpayer's level of sophistication.

In order to prevent the continuing trend established by the Heasley decision, we believe it is important that the records in cases which go forward establish one of the following: (1) the taxpayer has not attempted to assess his proper tax liability; or (2) the taxpayer's request for a waiver was given a full and fair consideration at the administrative level but, at that time, there was not sufficient information to warrant the granting of a waiver. This is not to say, however, that every case in which the taxpayer claims reliance on an advisor ought to be conceded.

Based on our review of the few facts presented to us in this case, we believe there is a significant litigation hazard concerning the waiver of the section 6661 penalty. The taxpayer traveled to Switzerland with a business advisor to determine the investment worthiness of [redacted]. We are unsure of the information which was presented to the taxpayer and his advisor during their meeting with [redacted] or the advice provided to the taxpayer by his advisor. This information can only, at this point, be elicited at trial, which is scheduled for [redacted]. As you have informed us, the taxpayer's advisor will testify. Our assumption that the taxpayer's advisor was independent from the shelter entities and the promoter bolsters the taxpayer's case. Presumably, this information was not obtained through discovery.

In addition, [redacted] prepared the taxpayer's tax returns for the years at issue. They relied extensively on the prospectus and the K-1s. There is no information concerning whether the accountants lacked the requisite information to prepare the returns. We assume that they informed the taxpayer that the deductions were proper; however, we note that the taxpayer has the burden to prove that he received such advice. Also, the taxpayer's immediate filing of amended returns and payment of tax upon discovery of problems with the [redacted] deductions, the fact that the RAR never considered whether [redacted] was a sham, the statement in the RAR about the partners' profit motive and the fraud action brought by the partners against the promoter, while not conclusive, are indications of the taxpayer's good faith. We also note your concern that the taxpayer's attorney has asserted that the amended returns were "qualified amended returns" which require an automatic waiver of the section 6661 penalties pursuant to section 6661(c) and Treas. Reg. § 1.6661-6(c).

Further, as you stated, there were no specific warnings in the prospectus concerning the possible imposition of the section 6661 penalties. The information in the prospectus concentrated on the potential profitability of the venture, rather than its tax attributes. We note that the Eleventh Circuit, in Karr, found the section 6661 warnings, which are not present in this case, of particular interest in affirming the Commissioner's determination that the 6661 penalties were warranted. Based upon this information, the taxpayer should be able to fashion a solid

argument that he reasonably relied in good faith upon the advice of professional advisors and the prospectus, and that he attempted to assess his correct tax liability.

On the other hand, the taxpayer is a sophisticated investor. Thus, the Heasley decision has less impact. In hindsight, based upon the taxpayer's level of income, it could be said that the taxpayer was searching for a way to reduce his tax liability. It is also plausible to argue that the taxpayer should have known that a tax deduction of almost four times his initial investment was too good to be true. In this regard, the entire transaction seems a bit suspicious and it is arguable that the taxpayer knew that the primary purpose of the transaction was the creation of tax benefits. The taxpayer's filing of amended returns shortly after receiving the NBAP also suggests that he may have been playing the "audit lottery."[1]

However, since the recent decision in Rousseau, it is possible that a court may not expect him to know more about the tax consequences of the transaction than his business advisor and accountant. Furthermore, if the taxpayer was truly defrauded as to the nature of the investment, it would not seem appropriate to impose the penalty against him. As mentioned, we believe the true resolution of the issue of whether the taxpayer's reliance was reasonable and in good faith can only be determined at trial, based upon the credibility of the witnesses.

The RAR makes no section 6661(c) waiver analysis. We know that the Service had the prospectus, copies of the returns, and was aware of the fraud action against the promoter at the time the RAR was prepared. In light of these facts, and without any discussion of section 6661(c) in the RAR, an argument that the taxpayer did not provide facts sufficient to warrant the Service's exercise of its waiver discretion may not be successful.

We admit, this case presents a close call. Our review of the available information indicates that there are significant litigation hazards concerning the waiver of the section 6661 penalty. We recommend settlement, if possible, at an amount in your discretion. However, we also do not believe the facts, as presently known, are so in favor of the taxpayer that they necessarily compel the exercise of the Commissioner's waiver authority at this time. If settlement cannot be reached, then this issue should be litigated. Concession of this issue can be

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[1]The committee reports on section 6661 state that the section was enacted to penalize taxpayers who take questionable positions, not amounting to fraud or negligence, on their returns in the hope that they will not be audited. See S.Rep. No. 494, 97th Cong. 2d Sess., 273-74 (1982).

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Please refer any inquiries to Tom Oswald, FTS 566-3442.

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